



Assessment of the Estonian notification in accordance with Article 458 of Regulation (EU) No 575/2013 concerning the application of a stricter national measure for residential mortgage lending

Introduction

On 18 May 2021 Eesti Pank notified the European Systemic Risk Board (ESRB) of its intention to extend the application of a stricter national measure concerning risk weights under Article 458(2)(d)(vi) of the Capital Requirements Regulation (CRR)¹. Eesti Pank is the designated authority in charge of the application of Article 458 of the CRR in Estonia.² The draft measure is a continuation of the credit institution-specific minimum level of 15% for the exposure-weighted average of the risk weights applied to the portfolio of retail exposures secured by mortgages on immovable property to obligors residing in Estonia. The measure applies to credit institutions that use the internal ratings-based (IRB) approach for calculating regulatory capital requirements.

Pursuant to Article 458(4) in conjunction with Article 458(9) of the CRR, the ESRB must provide the Council, the European Commission and Estonia with an opinion within one month of receiving the notification. The opinion must be accompanied by an assessment of the national measure in terms of the points mentioned under Article 458(2) of the CRR. The procedural framework for the provision of opinions under Article 458 of the CRR is clarified in Decision ESRB/2015/4³.

The ESRB's assessment focuses on the net benefits of the national measure for maintaining financial stability. In particular, the ESRB has assessed the rationale and merit of the measure against the following criteria:

- **Justification:** Has there been a change in the intensity of systemic risk and does it pose a threat to financial stability at the national level? Can alternative instruments provided for under CRD⁴ and CRR adequately and appropriately address the risk, taking into account their relative effectiveness?
- **Effectiveness:** Is the measure likely to achieve its intended objective?
- **Efficiency and suitability:** Will the measure achieve its objective in a cost-efficient way, i.e. are the instrument and calibration appropriate?

¹ See Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

² According to **Eesti Pank Act** § 241(6), Eesti Pank has the power to take measures related to Article 458 of the CRR.

³ See Decision of the European Systemic Risk Board of 16 December 2015 on a coordination framework for the notification of national macroprudential policy measures by relevant authorities, the issuing of opinions and recommendations by the ESRB, and repealing Decision ESRB/2014/2.

⁴ See Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

- **Proportionality and impact on the internal market:** Is there an appropriate balance between the costs resulting from the measure and the problem it aims to address, taking into account any potential cross-border spillover effects? Where appropriate, the ESRB may suggest amendments to the measure to mitigate potential negative spillover effects.

The ESRB's assessment draws on the information provided by, and discussions with, Eesti Pank and its staff.

Section 1: Description and background of the measure

1.1 Description of the measure

The existing measure consists of a credit institution-specific minimum level of 15% for the exposure-weighted average of the risk weights applied to the portfolio of retail exposures secured by mortgages on immovable property to obligors residing in Estonia. The exposures are referred to in this assessment as "Estonian mortgage loans". The measure is intended to support the resilience of banks and to ensure that they hold sufficient own funds to cover systemic risks related to mortgage loans and the residential real estate (RRE) market.

The measure applies to credit institutions licensed in Estonia that are authorised to use the IRB approach for calculating regulatory capital requirements ("IRB credit institutions") and have an exposure to Estonian mortgage loans. The measure applies to credit institutions on an individual and consolidated level, including subsidiaries of foreign credit institutions that are based in Estonia. Around 75% of Estonian housing loans are held by two IRB credit institutions which would fall under the scope of this measure.

The existing measure entered into force on 30 September 2019 and will remain in place until 29 September 2021. The measure is intended to be extended for two years. Since the impact of the draft measure, according to the information provided by Eesti Pank, may be higher than 25% of the risk weights applied by IRB credit institutions, Article 458(10) of the CRR does not apply.

Eesti Pank does not intend to request the reciprocation of the extended measure by other Member States given the currently limited activity and market share of foreign branches in the Estonian mortgage market. Only one foreign branch with a market share of around 1% provides housing loans in Estonia, and direct cross-border lending for house purchases is still insignificant.

1.2 Background of the measure

The proposed extension of the measure will continue to complement a set of macroprudential instruments already used by Estonian authorities. Currently, the other macroprudential policy tools in use are the following:⁵

⁵ See <https://www.eestipank.ee/en/financial-stability/macprudential-policy-tools>.

- Borrower-based measures applicable since March 2015 to new housing loans: an LTV limit of 85%, a DSTI limit of 50%, and a maximum maturity for housing loans of 30 years.
- An O-SII buffer of 2% applicable to three banks, including the two IRB banks, and an O-SII buffer of 1% applicable to one bank.⁶
- The countercyclical buffer (CCyB) is currently set at 0%.

In May 2020, the systemic risk buffer of 1% was put to zero owing to the COVID-19 pandemic.

According to Eesti Pank, the proposed extension of the measure aims to prevent a further decline in risk weights and address vulnerabilities in the RRE market and it will also help to ensure that active macroprudential buffers remain effective. If the risk weights were to decline further, the buffers would become less effective, because they are calculated on the basis of risk-weighted assets.

Section 2: Analysis of the underlying systemic risks

When the measure was introduced in 2019, the ESRB was of the view that the systemic risk related to RRE in Estonia had increased over recent years. The key risks identified in 2019 were house price growth, household indebtedness, mortgage lending growth and interconnectedness with the Nordic banking system.⁷

Real annual house price growth has accelerated further over the past few years, reaching around 10% in the fourth quarter of 2020 and the first quarter of 2021. While activity in the RRE market decreased in the second quarter of 2020 owing to the COVID-19 pandemic, with transactions declining to slightly above 4,000 from a quarterly average of around 6,000 in 2019, house prices were not significantly affected. The likelihood of the overvaluation of house prices has increased.⁸

Several factors have put upward pressure on house prices and are likely to continue to do so. Demand for housing has increased in Estonia, as a large birth cohort has reached the age of 30-35 years which tends to be a preferred/common time for house purchases. Savings have increased during the pandemic as consumption possibilities decreased. The second pillar of the pension system has become voluntary and could prompt households to take sizeable funds out from their pension system in the second half of the year. This may fuel further increases in activity and prices, when directed towards the RRE market. According to a survey, 24% of those in the second pension pillar are planning to leave their system, of which 15% plan to use the money to

⁶ See **Financial Stability Review**, May 2021, Eesti Pank, p. 17.

⁷ See ESRB report "**Vulnerabilities in the residential real estate sectors of the EEA countries**", September 2019.

⁸ The estimates point to an overvaluation of house prices by some 10% but are surrounded by high uncertainty. See **Financial Stability Review**, May 2021, Eesti Pank, Figure 12. These estimates are consistent with ECB internal estimates for overvaluation based on an inverted demand model and the price-to-income ratio.

purchase real estate.⁹ Finally, the environment of low interest rates contributes further to higher housing demand. Due to heightened uncertainty in the first half of 2020, housing supply is expected to remain somewhat lower in the short term. However, increased demand for housing and a positive economic outlook has increased confidence to start new builds, which helps to alleviate upward pressure on prices.

While indebtedness of Estonian households is lower than the euro area average, household debt continued to increase in 2020. Household debt stood at 72% of disposable income at the end of 2020 and at 41% of GDP (Q4 of 2020). Vulnerabilities may be aggravated by the large share of mortgages with variable interest rates, which remained broadly unchanged at around 90% since the 2019 assessment. However, mortgage debt tends to be concentrated among those households with higher income and larger financial assets which can more easily absorb the impact of adverse shocks. In 2019 the ESRB assessed vulnerabilities in the household sector to be material and the current situation suggests that this assessment has not fundamentally changed.

Housing loans represent a relatively large share of total loans in Estonia. In 2020, housing loans accounted for 43% of the real estate sector loan and leasing portfolio. The rate of growth in housing loans in Estonia has remained relatively high for several years now and stood around one-and-a-half times as fast as the average in the euro area. New loans grew by 14% year on year in the fourth quarter of 2020. According to the March 2021 forecast by Eesti Pank, the housing loan portfolio could grow by around 7% annually in the years ahead, which is faster than GDP growth or income growth. As a result, the household debt burden is likely to continue to increase.¹⁰ Demand for mortgage loans has been supported by the outlook of continued low interest rates, as well as increased competition between banks, since mid-2020¹¹ leading to favourable lending rates.

The Estonian banking sector remained highly concentrated, although the Herfindahl–Hirschman index declined in 2020. Nevertheless, at the end of 2020 the share of the two IRB banks was 75% of the total housing loan market. This reflects the crucial role played by the IRB banks in the supply of housing loans to households. For the two IRB banks affected by the measure, the shares of housing loans in their total loan portfolio and in total assets were 46% and 30%, respectively, by the end of 2020.

The share of loans with high LTV ratios has increased somewhat since the existing measure was implemented in 2019. The share of loans with LTV ratios between 85% and 90% increased in 2020, from around

⁹ See [Financial Stability Review](#), May 2021, Eesti Pank.

¹⁰ See [Financial Stability Review](#), May 2021, Eesti Pank.

¹¹ See [Financing of the economy](#), Eesti Pank, March 2021, Section 3.

12% to 16% of total loans.¹² If the systemic risk from borrowing should increase, it may be decided to tighten the regulation by limiting the use of exemptions or by taking other measures.

Section 3: Effectiveness and efficiency of the measure

3.1 How the measure addresses the identified risk

The proposed extension of the measure would complement a wider set of existing initiatives that have been introduced over several years to address risks in the Estonian banking and RRE sector. In addition to the current measure, which was introduced in 2019, in March 2015 Eesti Pank enforced three borrower-based requirements for credit institutions to be applied to mortgage loans.

According to Eesti Pank, the primary objective of the proposed extension of the existing measure is to prevent a further decline in risk weights applied by IRB credit institutions to the Estonian mortgage loan portfolio. This provides a macroprudential backstop, which in Eesti Pank's view will protect the resilience of IRB credit institutions against systemic risks related to mortgage loans and the RRE market. According to the authorities, the trend in declining average model-implied risk weights of the IRB banks has continued, from 13.4% since the introduction of the measure to 12.8% in the fourth quarter of 2020, reflecting the favourable economic conditions in recent years and the low interest rates that have bolstered loan quality.

Eesti Pank intends to use the measure in a primarily preventive, forward-looking manner. According to Eesti Pank the systemic risks in the Estonian RRE sector have not diminished despite some of the temporary effects of the pandemic. Therefore, taking a forward-looking approach, risk weights should be prevented from decreasing further. Otherwise, risk weights for exposures to residential mortgages may not sufficiently reflect the potential credit losses that could occur in the event of an economic downturn.

The measure is to be extended using an unchanged calibration. Eesti Pank based the calibration on an assessment of credit losses stemming from Estonian mortgage loans under a stress scenario. This scenario assumes a macroeconomic shock similar to that which affected Estonia in 2008-09 in the context of the global financial crisis. The shock corresponds to a cumulative decline in real GDP of 20%, a decrease in house prices of 50% and an increase in the unemployment rate to 20%. Replicating the stress test carried out in 2019 with end-2020 data would result in losses from housing loans of around 1.4% of the housing loan portfolio, and around 0.7% of total risk exposure. Given the current economic environment, Eesti Pank considers it appropriate to set the minimum level of the exposure-weighted average risk weight for residential mortgage loans at 15% as a precautionary measure.

¹² See **Financial Stability Review**, May 2021, Eesti Pank, Figure 20. LTVs above 85% are possible because Eesti Pank permits an exception where KredEx guarantees can be used to reduce the down payment to 10% of the value of the real estate being purchased. In its Financial Stability Review, Eesti Pank also suggests that if the systemic risk from borrowing increases it may limit these exceptions or take other measures.

The ESRB is of the view that while the measure is expected to have an immaterial effect on the actual capitalisation of the banks in the short term, from a forward-looking perspective, it prevents a further decline of risk weights for the RRE portfolio, thus acting as a backstop.

3.2 How the measure relates to possible alternatives

a) Increasing the risk weights for banks applying the standardised approach to credit risk (Article 124 of the CRR)

Article 124 of the CRR would not be effective in meeting the measure's objectives, given that 75% of the Estonian mortgage market exposures are held by IRB credit institutions. Furthermore, the risk weight of 35% under the standardised approach is considered sufficient compared with the proposed risk weight floor of 15% for IRB credit institutions.

b) Increasing exposure-weighted average loss given default (LGD) for all retail exposures secured by residential property for banks applying the IRB approach to credit risk (Article 164 of the CRR)

According to Eesti Pank, the lower risk weights for mortgage loans have been the result of a fall in the probability of default (PD) rather than in the LGD estimates. In fact, the average LGD rates have fallen by less than the PD and are more homogenous across banks. The ESRB is of the view that given the narrower focus of Article 164 of the CRR, i.e. only targeting the LGD and not the PD, any measure under Article 164 of the CRR would not sufficiently achieve the intended purpose of the 15% risk-weight floor. In particular, it could even lead to unintended results by affecting banks' risk weights in a disproportionate manner, given that the IRB risk-weight formula is a linear function of the LGD parameter.

c) Using the systemic risk buffer (Article 133 of the CRD)

Member States may introduce a systemic risk buffer (SyRB) to prevent and mitigate systemic or macroprudential risks not covered by the CRR or by Articles 130 and 131 of the CRD. The SyRB can be applied to all banks or to a subset of banks. Furthermore, the SyRB can be applied to all, sectoral or subsets of sectoral domestic exposures, exposures in third countries and all or sectoral exposures in other Member States.

The SyRB of 1% introduced on 1 August 2016 for all credit institutions was abolished in March 2020 in the context of the COVID-19 pandemic. Applying a SyRB would have an impact on all exposures, including, for example, credit to the corporate sector and SMEs. Therefore, such a measure would have sizeable side effects and would not achieve the desired impact of limiting risks related to residential mortgage loans. A sectoral SyRB applied solely to retail exposures secured by residential immovable property would not be as efficient in achieving the desired outcome of establishing a floor to prevent a further decline in risk weights. It would need to be set at a relatively high level to achieve the equivalent impact of the existing measure and would additionally affect, disproportionately, those banks that employ a more conservative risk assessment. The ESRB concurs with Eesti Pank that extending the already existing measure is preferable to changing the policy framework and introducing a new capital buffer requirement in the current highly uncertain environment.

d) Using the countercyclical capital buffer (Article 136 of the CRD)

Eesti Pank considers that the CCyB is not an appropriate tool to address sectoral systemic risk, as it would apply to all exposures in Estonia and not only to Estonian mortgage loans. The CCyB rate is applied as a percentage of the total amount of risk exposure and can therefore not be applied to specific subsets of exposures.

e) Using other measures

Since 1 March 2015, all banks operating in Estonia must comply with three requirements when issuing housing loans. These limits are an LTV limit of 85%, a DSTI limit of 50%, and a maximum maturity for housing loans of 30 years.

While borrower-based measures are fairly powerful tools, they apply to new loans only and therefore they affecting the flow only and not the stock of the RRE portfolio. Therefore, they cannot address the underestimation of risks that could result from a further decline in risk weights related to the stock of RRE exposures. Furthermore, Eesti Pank argues that the borrower-based measures introduced in 2015 were calibrated as a backstop on the basis of banks' actual loan terms and conditions and there is no evidence of a causal link between these measures and the observed decrease in risks weights.

Section 4: Analysis of the net benefits of the measure

4.1 Effects on financial stability, financial system resilience and economic growth

The proposed extension of the measure is expected to contribute to the resilience of the Estonian banking system and therefore possibly to enhance the overall resilience of the economy as a whole, albeit to a modest extent. Eesti Pank estimates the total increase in risk-weighted assets to be €160 million (2.2%) as at 31 December 2020. The weighted average CET1 ratio of the IRB credit institutions would decrease by approximately 0.8 percentage points. Compared to the actual weighted average CET1 ratio of 35.7% at the end of 2020, the impact is small. Notwithstanding the different impact on the capital ratios of individual banks, no IRB credit institution is expected to need to raise new capital following the extension of the existing measure.

According to Eesti Pank, the extension of the measure will contribute to the resilience of the Estonian banking system, which is key to the proper functioning of the Estonian economy. The Estonian economy is a small open economy vulnerable to negative developments in the external environment, with a high degree of dependence of the private sector on financing from the banking sector and a high level of concentration of the banking sector in the two IRB credit institutions affected by the measure. Therefore, in the view of Eesti Pank, in order to avoid a disruption in the supply of credit to the economy under negative macroeconomic scenarios, it is important to ensure that the capital buffers of IRB credit institutions are sufficient by means of macroprudential backstops that go beyond microprudential measures. In particular, since residential mortgage loans constitute a large share of the total exposure of the Estonian banking sector, if IRB credit institutions were to underestimate

the systemic risk related to lending for RRE, their assigned capital buffers may not be sufficient to withstand the potentially large loan losses that could result following a severe downturn in the real economy or in the RRE market.

4.2 Effects on both domestic and cross-border lending

Eesti Pank expects a limited impact given the sufficient capitalisation of Estonian IRB credit institutions.

Eesti Pank also expects the extension of this measure not to limit or significantly influence lending by credit institutions to other economic sectors.

With the vast majority of Estonian mortgage retail loans being held by IRB credit institutions, the likelihood of any material impact on cross-border lending is small. Eesti Pank estimates that more than 99% of Estonian mortgage loans held by IRB credit institutions had originally been issued in Estonia. Only one foreign bank branch provides housing loans in Estonia and direct cross-border lending for house purchases is still insignificant. In addition, the average risk weight applicable to mortgage loans for banks in other countries in the region is generally higher, which disincentivises banks to shift mortgage exposures from Estonia to other countries. Therefore, the likelihood of any direct impact on other Member States is small. According to Eesti Pank, the share of non-bank mortgage lending is also small. In addition, no comments have been raised by ESRB members which would point towards a negative impact on the Internal Market.

4.3 Effects on intragroup behaviour of credit institutions

Given that IRB credit institutions already meet the higher capital requirements, it is unlikely that the measure will cause a significant shift of operations within their group structures. Both of the said IRB credit institutions are subsidiaries of credit institutions residing in the European Union. However, the share of the Estonian subsidiaries in total assets of the whole group is only 5% and 2.3%, respectively, according to the banks' 2020 Annual Reports. Therefore, it is unlikely that the requirements will have any material impact on intragroup behaviour.

The development of cross-border mortgage lending and lending through branches should be monitored, as Eesti Pank does not intend to request reciprocation of the measure. In the absence of reciprocation, intragroup shifts in exposures might arise in order to circumvent the measure. Further analysis of developments at the level of individual institutions (in particular by the supervisory colleges of the banking groups concerned) should be undertaken should there be any significant intragroup activities in Estonian mortgage loans.

Conclusions

According to Eesti Pank, the main purpose of the proposed extension of the measure is to continue limiting further decreases in risk weights applied to the IRB bank portfolios of retail exposures secured by mortgages on immovable property to obligors residing in Estonia. Limiting the further decrease in risk

weights should support the resilience of banks and ensure that they hold sufficient own funds to cover systemic risks related to mortgage loans and the RRE market. Eesti Pank also highlighted that – while the measure has an immediate impact on risk weight levels in one particular institution – the measure has a broader, more pre-emptive and forward-looking impact overall and commensurate with its macroprudential purpose.

Systemic risk related to RRE in Estonia has increased over recent years, despite the COVID-19 pandemic.

The key risks are house price growth, household indebtedness, mortgage lending growth and interconnectedness with the Nordic banking system. The number of transactions and prices continued to increase in the RRE market. Household debt burden has increased and real estate prices are likely to be overvalued. A decrease in risk weights in the relevant IRB institutions could cause a reduction in the resilience to systemic risk.

The ESRB is therefore of the view that the proposed extension of the measure may help to maintain capital adequacy in IRB credit institutions in Estonia so as to mitigate a possible materialisation of systemic risk in the RRE market. While RRE systemic risk in Estonia has increased over recent years, the measure is pre-emptive, as it is aimed at ensuring that banks hold sufficient own funds to cover systemic risks should they materialise.

The ESRB is further of the view that the alternative macroprudential instruments listed in Article 458 of the CRR would not be appropriate to address the risk at hand, also under the current cyclical situation of the economy. Measures such as those listed under Articles 124 and 164 of the CRR, as well as the systemic risk buffer or the countercyclical capital buffer, are considered to be inappropriate since they do not provide the intended incentives, are too broad-based, may require the introduction of an equivalent new capital buffer requirement, which is not desirable in the current highly uncertain environment, and furthermore they do not address the relevant type of risk, exposure or credit institution.

Overall, the ESRB is of the opinion that the extension of the measure would not entail disproportionate adverse effects for the Internal Market or financial systems of other Member States. The measure would prevent a further decline in risk weights applied by IRB credit institutions to the portfolio of Estonian mortgage loans. Also, as the average applicable risk weight on mortgage loans of banks in other countries in the region is generally higher, this should not have a disproportionate adverse effect on the Single Market.